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SUBJECT: TREASURY A/S LOWERY MEETS WITH SAO PAULO CONTACTS

REF: BRASILIA 665

11. (SBU) Summary: Treasury A/S Clay Lowery's interlocutors during an April 4 Sao Paulo visit pointed to problems obtaining financing and skilled labor, along with the high and complicated taxes, as hindering the development of Small and Medium Enterprises (SMEs). A round-table with recipients of conditional cash transfer programs highlighted the value of such programs in helping parents to keep their children in school. The chief economists of several banks expressed confidence in Brazil's macroeconomic scenario and the direction of macroeconomic policy, although all see the microeconomic agenda lagging. U.S. businesses enumerated education, job creation and labor reform, tax reform, Intellectual Property Rights (IPR) protection and the need for trade agreements as their priorities for policy engagement with the GoB. Participants in a roundtable on infrastructure investment highlighted regulatory uncertainty, particularly environmental licensing as a principal obstacle to infrastructure investments in Brazil. End Summary.

12. (U) Background: Treasury A/S Clay Lowery met in Sao Paulo on April 4 with representatives of U.S. businesses, infrastructure investors, the Brazilian Banking Association (FEBRABAN) and had a round table discussion on financing for Small and Medium Enterprises (SMEs). Lowery visited Cidade Tiradentes, a low-income neighborhood in Sao Paulo, where he met with regional Vice-Mayor Arthur Xavier and discussed social and economic development problems with several beneficiaries of GoB conditional income transfer programs. Lowery also delivered a speech on poverty at the Sao Paulo branch of the Fundacao Getulio Vargas (FGV), a leading research institution. Lowery's delegation included Treasury DAS Nancy Lee, Western Hemisphere Office Director Ramin Toloui and deputy director Chris Kushlis. Consul General McMullen and DPO David Wolfe rounded out the USG delegation. Lowery noted to all his interlocutors that he had come to Brazil for the annual Inter-American Development Bank (IDB) meetings and was making use of the opportunity to get a deeper understanding the challenges of dealing with poverty in Brazil, the state of the Brazilian economy, infrastructure issues and U.S. business concerns. End Background.

SME Challenges: Finance, Skilled Labor, Informality  
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¶3. (U) Lowery's interlocutors made two principal points on the challenges facing Brazilian SMEs: the difficulty of gaining access to finance and problems finding skilled labor. Cidade Tiradentes roundtable participant Cicero Ferreira da Silva, owner of a video rental store that has grown to seven area outlets, complained of the lack of skilled labor available for hire in the area. This meant that his business assumed substantial training costs; Silva is investing in further developing his work force by paying for several workers to take college-level courses. Cibele Angela Miranda, who runs a small business that makes stamps, toys and educational materials, reinforced this point, noting that her business routinely faces problems finding skilled labor in the area. One source of labor was the Tiradentes municipality's vocational training program which provided laborers with some basic skills; this made it easier for these new hires to pick up job-specific skills.

¶4. (SBU) Tiradentes roundtable participants uniformly singled out the difficulty in accessing finance as a significant recurring problem for their SMEs. Silva noted his ongoing negotiations with his bank for the financing to open his seventh video rental outlet already had taken several months. Asked about financing from the National Economic and Social Development Bank (BNDES), the roundtable participants said that only large firms were able to obtain low-cost BNDES loans. Separately, FEBRABAN Chief Economist Luis Troster downplayed BNDES's role in SME finance, noting that 90% of its lending is to large corporations. He derided BNDES as an example of a regressive income-distribution program, since it draws its funding from a payroll tax (i.e. primarily from the working class) and does almost all its lending to larger, successful companies. ABN Amro representative Cesar Goncalves stated that government borrowing crowded out lending to SMEs by private banks. Goncalves noted that while there had been large credit growth over

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the last two years, including of the smallest size loans, most of this growth was in consumer lending, not SME financing.

¶5. (SBU) Luiz Pedutti, the Chief Executive of WAPPA, a Brazilian software startup that is currently drawing its financing from the limited venture capital market in Brazil, blamed the high level of informality among small businesses on the complex tax structure. Beyond the issue of high tax rates, even a reasonably well-financed and well-run business like his own, he said, had difficulty fulfilling the complicated tax filing requirements. Marcelo Toledo, an economist at leading Brazilian bank Bradesco, echoed this assessment at the FEBRABAN lunch. Toledo argued to Lowery that the GoB must sequence its reform efforts, first tackling government current expenditures, a sine qua non for tax reform, which would in turn begin to address the problem of informality.

#### Dealing with Poverty - Income Transfer Programs

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¶6. (U) Tiradentes Vice Mayor Xavier held a round-table with municipally employed social workers and beneficiaries of conditional income transfer programs. One of these credited the 40 Reais (about US\$19) per month that she received from a program for the prevention of child labor (PETI - Programa de Erradicacao do Trabalho Infantil) for allowing her to keep her daughter in school. Her daughter also was able to access municipally-sponsored after-school programs. Another mother said that PETI and the complementary municipal after-school programs were helping keep her son off the streets. This was important, since the 2.5 hour commute to work in Sao Paulo meant she was unable to provide after-school care. Janete Santos, a municipal social worker, stated that they municipality targets the 2,000 most vulnerable families in this low income district, ensuring they get access to those programs that are available. A/S Lowery assured the round-table participants that poverty reduction, including through institutions such as the IDB was a USG priority and thanked them for the opportunity to learn from their experiences.

Bankers: Macroeconomic Scenario Good

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17. (SBU) Over lunch hosted by FEBRABAN, chief economists of several banks told A/S Lowery that the macroeconomic situation was good (reftel). There was unanimity of opinion that President Lula would continue the same broad macroeconomic policy stance, despite having been forced to replace Finance Minister Antonio Palocci with BNDES President Guido Mantega. Alexandre Bassoli of HSBC stated that the external balance had been an anchor for the economy, with strong exports (export prices up 40% over 2002). Andre Loes of Banco Santander added that structural changes also had contributed to export performance, including targeted tax measures, a new awareness by business of the importance of exports, and Brazil's shift to being a net oil exporter as of this year. Bassoli added that the Lula administration deserved credit for improving debt dynamics, which were no longer hostage to the exchange rate.

18. (SBU) Bassoli argued that inflation was still volatile, having gone from 12.5% in 2002 to about 5% now (based on a rolling 12 month estimate), thus creating an interest rate premium. He further noted that disinflation since 2003 had been largely based on the exchange rate appreciation, which had restrained the prices of tradable goods. Although there might be a few changes in the personnel at the Central Bank, Bassoli did not expect any variations in monetary policy. (Note: On April 6 the Central Bank announced that two of its directors, Alexandre Scwhartsman and Sergio Darcy, would be leaving, to be replaced by Mario Mesquita, chief economist of ABN Amro and Paulo Viera da Cunha from HSBC Securities New York office. Most analysts believe the new directors will not change the bank's orthodox stance.)

19. (SBU) The biggest challenges facing Brazil right now, regardless of who wins the October election, affirmed Andre Loes, are the quality of the fiscal adjustment and the need for microeconomic reform. Brazil had achieved high primary surpluses, he explained, despite substantial growth in current expenditures, because revenue

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growth has been even stronger. This increasing tax burden, coupled with the complexity of the tax system, was a growing constraint for the economy and reduced potential growth. While new Finance Minister Mantega is expected to meet, although not exceed, the formal 4.25% of GDP primary surplus target, there is more concern about his ability to reign in primary expenditures, said Jose Pena Garcia of BankBoston. Pena Garcia also expressed concern about Lula's ability to push for microeconomic reforms, necessary to boost growth rates, during a potential second Lula administration. Leading opposition presidential candidate Geraldo Alckmin likely would pursue the microeconomic reform agenda more vigorously, Pena Garcia argued.

Amcham Concerns  
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110. (SBU) In a morning session with leaders the American Chamber of Commerce (Amcham), Mickey Peters of Duke Energy outlined to A/S Lowery U.S. business concerns and priorities. Peters enumerated education, job creation and labor reform, tax reform, Intellectual Property Rights (IPR) protection and the need for trade agreements as the main Amcham concerns. Elucidating on educational issues, Jim Whitaker of Intel highlighted problems with exclusion of certain societal sectors as well as lack of standards and transparency. The Amcham, he said, has a program to collect and disseminate best practices. Intel Capital, according to Whitaker, was investing \$50 million in technology startups in Brazil. Maria Fernanda Teixeira, (Formerly of EDS), noted that development of SMEs, tax reform, reduction of the infrastructure gap and improvements to the investment climate all played into the question of job creation. FGV researcher Paulo Figueiredo advocated addressing exclusion issues by asking firms to give preferences in contracting to SMEs owned by members of Brazil's excluded classes.

111. (SBU) The Amcham has lobbied both the GoB and USG hard to try to advance the WTO Doha Round (DDA) and Free Trade Area of the Americas (FTAA) process, according to Simone Aguiar, Amcham trade committee head and Latin American Director for JP Morgan Chase Vastera. Brazil and Mercosul were, de facto, being excluded from the web of bilateral FTA that the USG was advancing. He urged that the USG

make a few conciliatory gestures to Brazil, which would help maintain close coordination in the DDA and potentially open the way for renewed FTAA discussions. A/S Lowery noted that the USG has put a very aggressive agriculture offer on the table at DDA, which the EU has resisted. Brazil and the G-20, however, were reluctant to move as far as the USG and EU sought on services and non-agricultural market access (NAMA), complicating negotiations. But there was a desire from the agricultural committees in the U.S. Congress to complete an ambitious agricultural round, Lowery said, which created an opportunity that should not be wasted.

#### Infrastructure: Regulatory Uncertainty

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¶12. (SBU) Participants in a roundtable on infrastructure investment highlighted regulatory uncertainty as a principal obstacle to infrastructure investments in Brazil. GE's Alexandre Silva and Duke Energy's Mickey Peters pointed out that the regulatory agencies were under-funded and lacked qualified personnel. Alvaro Novas of major Brazilian construction firm Odebrecht suggested that the IDB make the establishment of professional regulatory institutions a condition for its infrastructure lending. Novas applauded the new IDB infrastructure fund, although he noted working with sometimes-inflexible multilateral institutions could be difficult. Novas and Sao Paulo State Secretary of Transportation Director of Planning Milton Xavier noted the concession law for infrastructure projects (most notably roads) functioned well. The project finance framework was problematic, however, because of a problem with the rules for accounting for project debt on individual company balance sheets.

¶13. (SBU) The environmental licensing problem came in for uniform criticism. Novas and Peters of Duke Energy noted that environmental licensing for a project could take as long as 4 years. The Public Ministry (akin to the attorney general's office) complicated the

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process tremendously, Novas said, by seeking injunctions halting the environmental licensing process without solid justification, Novas said. He warned that Brazil might face an energy shortage in 2008 or 2009 should several hydropower plants still awaiting environmental licensing not begin construction quickly.

¶14. (SBU) Eduardo Nishi, a lawyer who has focused on legislation creating the framework for Public-Private Partnerships (PPPs) in infrastructure investments, noted that the federal government has yet to put out for bids its first PPP project, despite the GoB's early hyping of PPPs. The law contained some innovations, for example allowing disputes to be settled by arbitration, but implementation has been slow. Although some states have moved to regulate state-level PPPs with more alacrity, they face financial limitations which limit their ability to finance their portions of PPPs, said Nishi.

¶15. (U) During his day in Sao Paulo Assistant Secretary Lowery delivered a speech on the importance the Bush Administration attaches to poverty reduction in the hemisphere and what lessons can be drawn from global experience. Lowery emphasized that countries that have successfully reduced poverty have all grown rapidly, maintained low inflation and sustainable public finances and pursued microeconomic reforms that spread opportunity, including opening markets, reducing barriers to starting a business, investing in health and education, and linking the poor to markets through infrastructure, strengthened property rights and increasing access to capital. In Latin America, the record on poverty reduction has been weak, with the exception of some countries such as Chile, Mexico, Costa Rica and Brazil. Finally, Assistant Secretary Lowery outlined the US priorities for the region, including debt relief for the poorest countries, expanding IDB lending to the private sector, tripling credit to small and medium sized enterprises, halving the cost of remittances, catalyzing private infrastructure investment, supporting the millenium challenge account programs and advancing our free trade agenda.

¶16. (U) This cable was cleared by Treasury and Embassy Brasilia.  
MCMULLEN